Internal Revenue Service

memorandum

TL-N-4208-89

CC:TL:TS/JLRICKS

date: 27 APR 1989

to: District Counsel, Seattle W:SEA
Attn: Henry Thomas Schafer

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Re: [redacted] v. Commissioner, Dkt. Nos. [redacted] and [redacted]

This tax litigation advice is in response to your memorandum dated February 27, 1989, requesting advice concerning questions regarding the application of section 6659, which Judge Cohen raised in her draft opinion in the above captioned cases.

ISSUES

1. Whether the Service, as a policy matter, should allow a taxpayer to concede certain grounds raised in the statutory notice of deficiency as the basis for the disallowed ITC and the loss when the result of the concession is the avoidance of the imposition of the addition to tax under section 6659 and additional interest under section 6621(c) based upon the Fifth Circuit decision in Todd v. Commissioner, 89 T.C. 912 (1987), aff'd, 862 F.2d 540 (5th Cir. 1988)?

2. In a case in which the taxpayers have overstated the adjusted basis of a master recording, causing an inflated basis for depreciation and investment tax credit to be claimed on their returns, to what amount does the 30% rate under section 6659(b) apply?

CONCLUSIONS

1. The Service, as a policy matter, does not accept a taxpayer's efforts to concede selectively a ground for the disallowance of the deficiency in order to avoid an addition to tax.

2. Since petitioners conceded that they did not acquire any equitable or legal title in the recordings, petitioners' correct adjusted basis for purposes of depreciation and ITC relating to the master recording is zero. Zirker v. Commissioner, 87 T.C. 970, 978 (1986). In the alternative, assuming arguendo, that the

Court finds that petitioners acquired title in the master recording, the adjusted basis of the master recording equals the acquisition price, reduced by the amount of any notes which do not constitute valid indebtedness. Further to the extent that petitioners have made a cash investment of $[redacted], their adjusted basis is limited by the maximum fair market value of the master recording, or $[redacted].

FACTS

Petitioners purportedly acquired a master recording from [redacted] on [redacted]. Petitioners allegedly purchased the master recording for $[redacted]. Petitioners paid a small down payment towards the purchase price equal to $[redacted] in cash and executed a $[redacted] short-term recourse promissory note, due [redacted]. The balance of the purchase price was payable by a long-term recourse promissory note with installments payable from sales of records. The long-term note was due [redacted]. On the date of purchase, petitioners also applied for a loan commitment from [redacted], and paid a $[redacted] loan commitment fee. In the loan commitment, [redacted] was obligated to refinance the long-term recourse note at its maturity. Besides petitioners' $[redacted] payment to [redacted] and their $[redacted] payment to [redacted], petitioners did not make any further payments with respect to their [redacted] investment.

On their income tax return for [redacted], petitioners claimed a loss of $[redacted] and an ITC of $[redacted] for tax year [redacted], relating to the alleged acquisition of the master recording. Shortly thereafter, petitioners filed an Application for Tentative Refund, claiming ITC carrybacks of: $[redacted] to [redacted]; $[redacted] to [redacted]; and $[redacted] to [redacted]. Petitioners claimed depreciation deductions and ITC based on the full purchase price of the recording, $[redacted]. Petitioners stipulated that in [redacted], the fair market value of the recording was between $[redacted] and $[redacted]. The stipulated range of value was based upon the differences in value assigned to the master recording in respondent's two expert appraisals of the recording.

On [redacted], the Service issued a statutory notice of deficiency to petitioners for their [redacted] and [redacted] tax years. The statutory notice of deficiency pertained to petitioners' alleged investment in [redacted], but did not address their alleged investment in the [redacted] master recording. On [redacted], respondent filed an amended answer in Docket No. [redacted], claiming increased deficiencies in income tax for years [redacted] and [redacted] of $[redacted] and $[redacted], respectively, due to the disallowance of ITC related to petitioners' investment in [redacted]. Respondent also claimed additions to tax under section 6659 for [redacted] and [redacted] of $[redacted] and $[redacted], respectively. Respondent has the burden of proof on these new issues.

On [redacted], respondent mailed a statutory notice of deficiency to petitioners relating to tax years [redacted] and [redacted]. Respondent determined that the petitioners' losses and credits should be disallowed based upon seven grounds: (1) petitioners did not acquire equitable, legal, or other interest in the recording; (2) petitioners were not engaged in a trade or business with respect to their interest in the recording; (3) petitioners did not hold the recording for the production of income; (4) petitioners failed to establish that they had a basis in the recording upon which to claim depreciation or investment tax credits; (5) the recording was not placed in service; (6) petitioners used an improper method of depreciation for the recording; and (7) the recording did not qualify for ITC.

In the statutory notice of deficiency, the Service determined that the section 6659 and 6621(c) penalties applied. In calculating the section 6659 penalty, the Service compared the value of the master recording petitioners claimed on their return, $[redacted], with the correct value of the recording, $0.

Petitioners have conceded in the stipulation of facts that: (1) they never purchased or acquired title to the master recording; and (2) the long-term recourse promissory note and the related [redacted] loan commitment are shams, lacking economic substance. Petitioners argue that the losses and the ITC are disallowed for only the following select reasons stated in the statutory notice: (1) petitioners did not acquire a legal or equitable interest in the recording; (2) petitioners were not engaged in a trade or business; (3) petitioners did not hold the recording for the production of income; and (4) the recording was not placed in service for the years in issue. As a result of these selective concessions, petitioners argue that the underpayment of tax was not "attributable to" a valuation overstatement. Thus, petitioners assert that section 6659 does not apply under the analysis set forth in Todd v. Commissioner, 89 T.C. 912 (1987), aff'd, 862 F.2d 540 (5th Cir. 1988). Respondent, on the other hand, contends that the deficiency was disallowed for the years in issue for all of the reasons stated in the deficiency notice.

On brief, respondent argued that a valuation overstatement existed since the value of the master recording claimed on the return, $[redacted], was greater than [redacted]% of the actual fair market value of the master, between $[redacted] and not more than $[redacted]. Respondent also cited to McCain v. Commissioner, T.C. Memo. 1987-285, aff'd without published opinion, No. 87-7545 (9th Cir. Feb. 16, 1989) and Secoy v. Commissioner, T.C. Memo. 1987-286, aff'd without published opinion, No. 87-7543 (9th Cir. Feb. 16, 1989), two [redacted] cases in which the Tax Court upheld the imposition of the section 6659 addition to tax against the investors based upon the rationale in Zirker v. Commissioner, 87 T.C. 970 (1986).

DISCUSSION

ISSUE # 1

In her letter dated [redacted], Judge Cohen asked respondent to comment upon its views regarding selective concessions. The Service, as a policy matter, believes that selective concession by petitioners of a ground for an adjustment should not be permitted when the purpose of the concession is simply in order to avoid an addition to tax. We are not aware of any other situation, outside of the shelter area, in which the Court has found that the ground upon which the deficiency is sustained impacts upon the application of a penalty. For example, the application of the negligence and fraud penalties is not affected by the grounds upon which the deficiency is based. Accordingly, the Todd decision has created an anomalous situation in the tax shelter area.

Since her [redacted] letter to you, Judge Cohen has issued her opinion in McCrary, an AEL master recording case. 92 T.C. No. 50. McCrary is quite similar to your case in that the petitioners conceded certain grounds in order to avoid application of the section 6659 addition to tax and section 6621(c) add-on interest. Slip op. at 37. Accordingly, your response should address three points: (a) the Service's position on selective concession to avoid an addition to tax; (b) the Service's position on the correctness of Todd and its progeny, McCrary; and (c) the Service's position that, assuming the Court accepts petitioners' selective concessions, these petitioners are liable for the section 6659 addition to tax.

(a) Selective Concessions.

We could argue, under McGowan v. Commissioner, 67 T.C. 599 (1976), that the Tax Court should, in the interest of justice, reject petitioners' selective concessions and decide the grounds sustaining the deficiency. In McGowan, the Service made a unilateral concession as to the only issue in controversy and requested that the Court enter a decision of no deficiency without an opinion. Petitioners objected to the concession and desired a written opinion on the merits of the issue because of its recurrent nature and impact on thousands of Rhode Island employees. The Court found that, in the interest of justice, respondent's concession should be rejected. The Court noted that, among other reasons, many taxpayers would be affected by the outcome of the case and an expeditious resolution of the issue was necessary. 67 T.C. at 607-608.

However, even if the Tax Court decided to reject petitioners' selective concessions and go to trial on the penalty issues, petitioners could accomplish the same result as selective concessions using other means. Petitioners could admit enough underlying facts regarding the select grounds petitioners wanted to concede that the Court would be required to make a finding in petitioners' favor on these issues. Accordingly, we do not believe that the problem lies in whether selective concessions should be allowed as a policy matter, but with the rationale of the Todd opinion itself.

(b) Todd and McCrary.

In a case quite similar to the case at bar, the Tax Court allowed the petitioners to concede certain grounds in order to avoid the application of the section 6659 penalty and 6621(c) additional interest. In McCrary v. Commissioner, 92 T.C. No. 50 (April 17, 1989), petitioners invested in the American Educational Leasing ("AEL") master recording leasing program. Respondent disallowed petitioners' claimed ITC, rental expenses, and distribution fees on their Schedule C resulting from their AEL investment. Respondent listed numerous grounds for the disallowance of these deductions and credits in the deficiency notice, including: (1) the transaction was not conducted at arm's-length at fair market value; (2) the transaction lacked economic substance; and (3) petitioners were not engaged in a trade or business entered into for profit. If the above determinations were not sustained, the Service further determined that, among other things, the ITC is disallowed because: (1) the petitioners have not established "that the fair market value of basis of the alleged asset is other than zero"; (2) the asset was not placed in service in the year claimed; and (3) that the asset is a license. The Service also asserted additions to tax, including section 6659, and additional interest under section 6621(c) in the deficiency notice.

To avoid the section 6659 addition to tax under the rationale in Todd, petitioners conceded, prior to trial, that the ITC should be disallowed because the agreement was a license rather than a lease. McCrary, slip op. at 22. Regarding the rental expense and distribution fees, the Tax Court found that petitioners lacked an actual and honest intention to make a profit. Petitioners did not contend that there was an objective possibility that they could make a profit from the AEL transaction or that the tape had a value of $185,000.

In its findings of fact, the Court found that petitioners were not entitled to include the $185,000 note from AEL to IHI in calculating the credit base. McCrary, slip op. at 17, 36. In addition, the Court found that the master recording was produced at a cost not exceeding $330 and its fair market value was negligible. Id., slip op. at 17n.2, 36. Petitioners did not dispute these findings.

The Court in McCrary, following the Tax Court and the Fifth Circuit opinions in Todd, relied upon the formula stated in the Joint Committee of Taxation's General Explanation of the Economic Recovery Tax Act of 1981 ("Blue Book") to determine the amount of the underpayment attributable to a tax motivated transaction. Based on the language in the Blue Book, the Fifth Circuit in Todd found that the portion of the underpayment attributable to a valuation overstatement is "determined by comparing the taxpayer's (1) actual tax liability (i.e., the tax liability that results from a proper valuation and which takes into account any other proper adjustments) with (2) actual tax liability as reduced by taking into account the valuation overstatement." Todd, 862 F.2d at 542-543. Accordingly, the Fifth Circuit in Todd upheld the Tax Court's determination that where the taxpayer's claimed tax benefits are inappropriate altogether (e.g., because the asset was not placed in service), the taxpayer's actual tax liability taking into account all other property adjustments is the same as the taxpayer's actual tax liability, adjusted for the valuation overstatement. Id. Accordingly, no part of the underpayment would be attributable to the valuation overstatement.

Following the Todd rationale, the Court in McCrary found that section 6659 would not apply to that portion of the underpayment caused by the inflated ITC. In so holding, the Tax Court neglected its findings that (1) the fair market value of the master recording was negligible, and (2) petitioners were not entitled to include the $185,000 note from AEL to IHI in calculating the credit base. The Tax Court noted that the Fifth Circuit had agreed that Congress intended "to determine section 6659 liability 'after' taking account of any other proper adjustment to tax liability." 862 F.2d at 542. In addition, the Court believed that the petitioners' concession to avoid the section 6659 penalty was a "Pyrrhic victory" since they would still be liable for the section 6661 penalty. McCrary, slip op. at 40-41.

Under this same interpretation, the Court also found that section 6621(c) was inapplicable to the portion of the underpayment attributable to the concession that the agreement was a license rather than a lease. The Court found that in applying the same Fifth Circuit formula as that for section 6659, the underpayment attributable to the conceded ITC is not attributable to a tax-motivated transaction listed in section 6621(c)(3). Although the Court recognized that the ITC would have been included as a tax motivated transaction under the alternative theories of sham or lack of profit objective, the Court stated that:

> We believe, however, that the intended deterrent effect of section 6659 and 6621(c) has been advanced by petitioner's concession, and reaching out further to penalize petitioners would be "too draconian." See Todd v. Commissioner, 862 F.2d at 545 n.15, quoted above.

McCrary, slip op. at 46.

It is the position of the Service that the Tax Court and the Fifth Circuit incorrectly interpreted the phrase "attributable to" in Todd for purposes of applying the section 6659 penalty. Both the Tax Court and the Fifth Circuit relied upon the statement in the Blue Book that:

> The portion of a tax underpayment that is attributable to a valuation overstatement will be determined after taking into account any other proper adjustments to tax liability.

Based upon this statement, these Courts "incorrectly reasoned that if another ground besides valuation overstatement supports a deficiency, the deficiency cannot be attributable to a valuation overstatement." McCrary, slip op. at 50 (Gerber J., dissenting). As a result of this reasoning, respondent is forced to pursue the overvaluation theory as the sole ground for the deficiency in order to ensure that the Court will impose the section 6659 addition to tax.

The Tax Court's and the Fifth Circuit's reliance on the Blue Book explanation is misplaced for two reasons. First, the Blue Book is not considered to be part of the official legislative history. Second, as stated in Judge Gerber's dissenting opinion in McCrary, slip op. at 52, the sentence upon which these Courts rely:

> does not contemplate and was not intended to include situations where the deficiency related to a single transaction that could be sustained on multiple grounds. Rather, the sentence was intended to define or explain "attributable to" where there are several different portions of a deficiency, some admittedly attributable to a valuation overstatement and others not. The majority's reading of the Blue Book creates an unwarranted hierarchy where valuation overstatements are subordinated to every other ground for redetermining a deficiency. If anything, considering the crux of the abusive shelter problem, we should give priority to grounds that support a valuation overstatement.

In the context of a closely related statute, section 6621(c), the Second Circuit found that the word "attributable" means "capable of being attributed." Irom v. Commissioner, 886 F.2d 545 (2d Cir. 1989). In Irom, the Second Circuit held that the Tax Court should have decided whether the petitioner was liable for section 6621(c) additional interest even though the Commissioner's motion for summary judgment asserted, and the Tax Court sustained, the deficiency based on a ground that would not be a basis for imposing the section 6621(c) interest. 886 F.2d at 547. The Second Circuit reasoned that the phrase "attributable to" should be interpreted to allow the imposition of section 6621(c) additional interest when the deficiency is "capable of being attributed" to a tax motivated transaction. The Second Circuit stated that:

> We do not think Congress intended to preclude additional interest for deficiencies that are capable of being attributed to tax-motivated transactions simply because the Commissioner seeks summary judgment for the deficiency on other grounds.

Id.

This interpretation of the phrase "attributable to" allows the imposition of the section 6659 penalty when the valuation overstatement is a cause of the disallowance of the deficiency, but not necessarily its only cause. Thus, under respondent's interpretation, overvaluation can be one of a number of theories which resulted in the underpayment.

This broader interpretation of the "attributable to" language more closely effectuates Congress' intent in passing the statute. McCrary, slip op. at 51-52 (Gerber, J., dissenting). Congress intended section 6659 to penalize taxpayers who overstate the value or adjusted basis of property. H. Rep. No. 201, 97th Cong., 1st Sess. 243 (1981). This section was meant to be a tool to help the Tax Court to deal with its backlog, which included numerous tax shelter cases involving significant property valuation questions. H. Rep. No. 861, 98th Cong., 2d Sess. 985 (1984). The majority's interpretation of the phrase "attributable to" is inconsistent with and frustrates the policy that Congress sought to implement.

The Todd Court's narrow interpretation of the "attributable to" language produces anomalous results, as illustrated in this case. This rationale encourages taxpayers, like petitioners, with no hope of prevailing on the merits of the case, to petition the Tax Court and concede the underlying deficiency based on an issue which will have the effect of avoiding the section 6659 addition to tax and section 6621(c) additional interest. Yet, the evidence in this case reflects that petitioners wildly overstated the adjusted basis of their master recording. Petitioners are responsible to accurately state the value of the master recording. Accordingly, section 6659 should be applied in this case.

Moreover, section 6621(c) should be applied because there is a substantial underpayment which is attributable to "tax motivated transactions," as defined in section 6621(c)(3). The evidence in this case shows that petitioners made a valuation overstatement, within the meaning of section 6659(c). I.R.C. { 6621(c)(3)(A)(i). In addition, the evidence shows that petitioners did not engage in these activities for profit. Temp. Treas. Reg. { 301.6621-2T, A-4(1); <u>see</u> Stip. 4(b) and (c). Moreover, petitioners have conceded that the long-term recourse promissory note and the related [redacted] loan commitment are shams without economic substance. The Tax Court has held that the term "sham or fraudulent transaction" for purposes of section 6621(c)(3)(A)(v) includes transactions in which the Court has found that a debt is not bona fide and, thus, lacks economic substance. <u>Bailey v. Commissioner</u>, 90 T.C. 558, 628 (1988); <u>Taft v. Commissioner</u>, T.C. Memo. 1987-542. Petitioners are responsible for not engaging in a tax motivated transaction under section 6621(c)(3). Accordingly, section 6621(c) should also be applied in this case.

It is the position of the Service that petitioners' selective concession of certain grounds for the disallowance of the deficiency does not affect the application of the section 6659 or section 6621(c) penalties. The issue concerning the disallowance of a taxpayer's deductions and credits and the penalty issues raised under sections 6659 and 6621(c) are two separate legal issues. For tax years [redacted] and [redacted], where the section 6659 penalty was raised by the Internal Revenue Service in the statutory notice of deficiency, petitioners bear the burden of showing the addition to tax under section 6659 and additional interest under section 6621(c) does not apply. T.C. Rule 142(a); <u>Heasley v. Commissioner</u>, T.C. Memo. 1988-408. For tax years [redacted] and [redacted], where respondent first raised the section 6659 penalty in its amended answer, respondent bears the burden of proof on this issue. T.C. Rule 142(a). Petitioners' selective concession of certain grounds for the disallowance of the deficiency does not overcome their burden regarding the application of these penalties because the application of the section 6659 addition to tax and section 6621(c) additional interest are separate issues in which the Court must make findings concerning the value or the adjusted basis of the property for section 6659, or whether a tax motivated transaction has occurred for section 6621(c). Accordingly, the issues of (1) the overvaluation of the adjusted basis of the master recording and (2) whether a tax motivated transaction has occurred are still at issue in this case.

Furthermore, it is clear that the Court must still determine a taxpayer's liability for additions to tax under section 6653(a) or 6653(b) even if the parties have already stipulated as to the taxpayer's correct income and tax for the period and even though to do so would require the Court to review evidence not necessary to a determination of the taxpayer's income tax. Leroy Jewelry Co., Inc. v. Commissioner, 36 T.C. 443 (1961). It is no different to require the Court in this case to make specific factual findings of overvaluation so as to determine if any portion of petitioners' deficiency can be attributed to a "valuation overstatement."

The Tax Court's reluctance to make findings in order to decide a separate penalty issue is contrary to the intent of Congress. McCrary, slip op. at 51-52 (Gerber, J., dissenting). In the Conference Agreement accompanying section 6621(c), Congress urged the Tax Court to "assert, without hesitancy in appropriate instances, the penalties that Congress has provided." H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 985 (1984). Following this mandate, the Tax Court has asserted section 6621(c) on its own motion when it found that the addition to tax was appropriate. Johnson v. Commissioner, 85 T.C. 469 (1985); Frates v. Commissioner, T.C.M. 1987-79. It is inconsistent with this Congressional mandate for the Court to forego finding a valuation overstatement or a tax motivated transaction in order for the section 6659 penalty or section 6621(c) additional interest to be imposed.

We note that in many circumstances, the approach set forth in Todd does not eliminate the necessity of addressing the valuation issue. McCrary, slip op. at 54 (Gerber, J., dissenting). As a practical matter, the Court generally makes findings regarding the fair market value of the shelter asset in determining whether a sale has occurred for tax purposes, Grodt and McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981), and in determining whether the transaction itself lacks economic substance. Heasley v. Commissioner, T.C. Memo. 1988-408. In addition, in both Noonan v. Commissioner, T.C. Memo. 1986-449 and McCrary v. Commissioner, 92 T.C. No. 50 (April 17, 1989), the Tax Court addressed the valuation issue, although it did not apply the section 6659 addition to tax.

(c) Petitioners' Concessions.

If the Court decides to accept petitioners' selective concessions, it is the Service's position that the section 6659 penalty and section 6621(c) additional interest would still be applied.

1. Section 6659 Addition to tax

Petitioners conceded the deficiency on four grounds. It is the position of the Service that if any one of the four grounds can support the application of the section 6659 penalty, the section 6659 penalty should apply. One of the grounds upon which petitioners conceded the deficiency was that petitioners did not acquire sufficient legal or equitable title or other interest in the recording to support the claimed losses and investment tax credits. The Tax Court has upheld the application of the section 6659 penalty based upon its determination that no sale of the subject property occurred and that title did not pass to the petitioners. See, e.g., Zirker v. Commissioner, 87 T.C. 970 (1986); Warren v. Commissioner, T.C. Memo. 1989-34. In these cases, this Court has reasoned that since no sale occurred, petitioners' correct adjusted basis in the property is zero. Zirker, 87 T.C. at 978; Warren, 56 T.C.M. (CCH) 1125, 1135. Since petitioners' concession that they did not acquire sufficient equitable or legal title in the recording supports the imposition of the section 6659 addition to tax, the addition to tax should be applied in the case at bar.

Petitioners' selective concessions highlight the inconsistencies in the application of the section 6659 penalty under the Zirker and Todd cases. The approach taken by the Court in Zirker recognizes that the statutory notice of deficiency sets up a hierarchy of grounds upon which the deficiency can be disallowed. This hierarchy is based upon the facts which the Court must find in order to reach the issue. Generally, the first grounds set forth are the ones upon which all of the claimed deductions and credits are disallowed. Under the method followed in Zirker, the deductions and credits in the case at bar can be disallowed based on the threshold issue, i.e., that no sale of the master recording occurred. Since this Court has imposed the section 6659 addition to tax based upon this ground for the disallowance of the deficiency, the section 6659 penalty should be applied.

However, the analysis in Todd and McCrary yields a different result. Under the rationale in Todd, the Court could pick any ground which would cause the disallowance of all deductions and investment tax credits relating to that asset as the basis for disallowing the taxpayer's deficiency. Todd, 89 T.C. 918-920 (1987); McCrary 92 T.C. No. 50. In the case at bar, the Court could choose any one of the four grounds which petitioners conceded upon which to base its disallowance of the deficiency. The consequence of determining that: (1) an asset was not placed in service during the years in issue; (2) that the petitioners did not acquire sufficient legal or equitable title in the recordings; (3) that petitioners were not engaged in a trade or business with respect to the master recording; and (4) that the recording was not held for the production of income is to disallow all deductions and credits relating to that asset. If the Court chose a ground other than petitioners did not acquire sufficient equitable or legal title to the property, which would be further down in the hierchy of issues, the section 6659 penalty would not apply.

2. Section 6621(c) Additional Interest

It is the position of the Service that if any one of the grounds upon which petitioner based its concession of the deficiency or a portion of the deficiency can support the application of section 6621(c) additional interest, section 6621(c) additional interest should apply. In the stipulation of facts, petitioners conceded that the long-term recourse promissory note and related [redacted] loan commitment are "shams without economic substance." Stip., preamble, page 1. The Tax Court has held that the term "sham or fraudulent transaction" for purposes of section 6621(c)(3)(A)(v) includes transactions in which the Court has found that a debt is not bona fide and, thus, lacks economic substance. Bailey v. Commissioner, 90 T.C. 558, 628 (1988); Taft v. Commissioner, T.C. Memo. 1987-524. Since petitioners' concession that the long-term recourse promissory note and [redacted] loan commitment are shams without economic substance supports the imposition of section 6621(c) additional interest, section 6621(c) additional interest would be applied in the case at bar.

We note that the analysis in Todd and McCrary would also yield a different result in the section 6621(c) context. Under the rationale in Todd and McCrary, the Court could choose any ground upon which petitioners conceded upon which to base its disallowance of the deficiency. If the Court chose a ground for concession other than the long term debt and [redacted] loan commitment are shams without economic substance, the section 6621(c) additional interest would not apply.

Accordingly, under Todd and McCrary, the fate of the section 6659 penalty and 6621(c) additional interest hinges upon the theory upon which the Court feels inclined to disallow the investors' deductions and credits. Congress certainly did not intend this result.

3. This Case is Factually Distinguishable from Todd and McCrary

This case is factually distinguishable from Todd and McCrary. Therefore, the holdings in these cases should not apply to the case at bar. Here, the petitioners have conceded a ground upon which the imposition of section 6659 and 6621(c) can be based. On the contrary, in Todd, the Court determined only that the asset was not placed in service as the basis for the disallowance of the deficiency. In McCrary, petitioners conceded that the ITC should be disallowed on the sole ground that the lease was a license.

Petitioners' concession of a ground upon which sections 6659 and 6621(c) can be imposed is significant to warrant a different result than that in Todd and McCrary. Because of petitioners' concessions, the Tax Court is not burdened "with deciding difficult valuation issues where a case could be easily decided on other grounds." 862 F.2d at 544. Further, in light of petitioners' concessions, the application of the section 6659 penalty would be imposed on taxpayers whose overvaluation of the adjusted basis of their asset was relevant to the determination of their actual tax liability. Id.

ISSUE # 2

The Court has also asked us to discuss the Service's position regarding the correct adjusted basis of petitioners' investment in the master recording to be used in determining the amount of the underpayment of tax which is attributable to a valuation overstatement. Section 6659(c) provides that:

> there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

The reference in the opening brief to the fair market value of the master recording in determining that the property was overvalued in excess of [redacted]% drew Judge Cohen's wrath in her draft opinion. Resp. Br. at p. 14-15. It is the petitioners' adjusted basis of the asset, and not its fair market value, which must be determined in connection with their entitlement to depreciation deductions. I.R.C. § 1.167(a)-1 and (g)(1); Kovacevich v. Commissioner, T.C. Memo. 1986-513. Accordingly, in determining whether a valuation overstatement exists under section 6659(c) in the case at bar, the Court's focus is whether the adjusted basis of the master recording claimed on the return is greater than [redacted]% of the correct adjusted basis in the recording. Kovacevich v. Commissioner, T.C. Memo. 1986-513. Under certain circumstances, the adjusted basis may be determined with reference to the fair market value.

The primary argument of the Service is that, since petitioners conceded that they did not acquire any equitable or legal title in the recordings, petitioners' correct adjusted basis for purposes of depreciation and investment tax credit relating to the master recording is zero. Zirker v. Commissioner, 87 T.C. at 978; Warren v. Commissioner, T.C. Memo. 1989-34. Since the adjusted basis of the master recording petitioners claimed on the return, $[redacted], is more than [redacted]% of the amount determined to be the correct adjusted basis, zero, an addition to tax equal to [redacted]% of the underpayment attributable to the valuation overstatement is appropriate. I.R.C. § 6659(a) and (b). The [redacted]% rate is clearly applicable to the extent that the underpayment is generated by depreciation deductions and ITC to which petitioners were not entitled. Zirker, 87 T.C. at 979-980.

In the alternative, assuming arguendo, that the Court finds that petitioners acquired title in the master recording, the Service takes the position that the adjusted basis of the master recording is its acquisition price, reduced by the amount of any notes which do not constitute valid indebtedness and limited by the maximum fair market value of the master recording. Such an approach to determining the adjusted basis of an asset was adopted by this Court in Noonan v. Commissioner, T.C. Memo. 1986-449. In Noonan, this Court determined that for purposes of applying section 6659, the petitioners' claimed adjusted basis in their refrigerated containers for ITC and depreciation deductions "must be reduced by the amount of the notes [which the Court found constituted invalid debt for tax purposes] and, to the extent represented by cash, limited to the maximum fair market value of the container interest." Noonan, 52 T.C.M. (CCH) 534, 553.

In the case at bar, petitioners conceded that the long-term recourse promissory note and the related [redacted] loan commitment are shams, lacking economic substance. It is respondent's position that all of the financing, including the short-term recourse promissory note, are shams lacking economic substance. Following the formula set forth in Noonan, petitioners' claimed adjusted basis in the master recording ($[redacted] would be reduced by the amount of the invalid indebtedness ($[redacted]).

However, in the case at bar, the more relevant part of the formula is the portion which focuses on the amount of petitioners' cash investment, limited by the maximum fair market value of the asset.[1] Petitioners made a cash investment in the

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[1] Although not an issue in the case at bar, we believe that the formula is ambiguous in the situation where (1) the petitioner's claimed adjusted basis, when reduced by the amount of the invalid debt, yields an amount which is greater than (2) petitioner's cash investment, limited by the fair market value of the asset. For example, assume that the petitioner's claimed adjusted basis, cash investment, and the fair market value of the

master recording totaling $[redacted], viz, - a down payment of $[redacted] plus the [redacted] loan commitment fee of $[redacted]. Since the evidence shows that any cash payments in excess of the fair market value of the master recording are payments for the anticipated tax benefits projected, the adjusted basis should be limited to the maximum fair market value of the master recording.

Respondent has provided testimony of two expert witnesses regarding the value of the master recording. Wiedenman indicated in his report that it was worth $[redacted] (assuming clear title); Bonetti indicated in his report that it was worth $[redacted] (assuming clear title). By stipulation, petitioners admitted that it was worth no more than $[redacted], and respondent stipulated that it was worth at least $[redacted], assuming petitioners even acquired an interest. Accordingly, from this record the Court can find that the master recording had a maximum fair market value of $[redacted].

Applying this Court's rationale in Noonan, if petitioners acquired any interest, petitioners' adjusted basis in the master recording for purposes of section 6659 is $[redacted]. Petitioners' claimed adjusted basis, $[redacted] is reduced by $[redacted], the amount of the notes which constitute invalid indebtedness. Since petitioners made a cash investment of $[redacted], their adjusted basis is limited to $[redacted], the maximum fair market value of the master recording stipulated to by the parties.

If you have any questions regarding this tax litigation advice, please contact Jo Lynn L. Ricks at FTS 566-3350.

MARLENE GROSS

By: Kathleen E Whatley
KATHLEEN E. WHATLEY
Chief, Tax Shelter Branch

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asset are the same as in the case at bar. However, further assume that the Court determined that a $420,000 note was not genuine indebtedness. Under the formula stated in Noonan, it is unclear whether the Court would find that the petitioner's adjusted basis should be $[redacted] (petitioner's claimed adjusted basis, $[redacted], reduced by the amount of the invalid debt, $420,000) or $[redacted] (petitioner's cash investment, $[redacted], limited by the fair market value of the asset). It is respondent's position that petitioner's correct adjusted basis should be $[redacted].